COVID-19 Changes the Conversation

As firms begin to pursue new opportunities, strategies include offensive capital raising and weighing the impact of potential policies on the horizon.

June 16, 2020

Capital Raising at 2-3x 2019 Volumes Highlights Continued Defensive and Rising Offensive

Companies have recently accelerated capital raising, as they shift focus from preserving liquidity to pursuing new opportunities. A similar trend took place during the Great Recession.

In 2008 and 2009, about 200, or one in three firms who raised cash from a primary follow-on equity offering subsequently spent cash on M&A within two years. About 100 of these firms raised over $100mm and then on average spent more than that amount on cash M&A. Generally, firms took the opportunity to issue at above-average equity prices with the median issue price at ~70% of the prior 52-week high

In the past few months, firms have begun tapping multiple markets, utilizing debt, hybrid securities, and private capital markets often with the stated intention of using the capital for M&A opportunities. Others have raised funds by selling long-held stakes in other companies. When most investors became hesitant to contribute capital shortly after COVID-19 rapidly pervaded the U.S., many firms got creative and found open channels to raise funds such as divesting assets to private equity companies. Public companies raising capital through private offerings experience median outperformance above their sectors by 7% following these transactions. Prior to COVID-19, reactions were lower, with median sector outperformance of just under 3%. Overall, investors have been highly receptive to these capital raises by strong companies.

As the economy moves toward recovery, bolt-on M&A transactions may be the first deals to resume before transformative deals ramp back up. Raising capital now could have a dual benefit: if the economic environment suffers, liquidity from capital raises will help prevent investor concerns about a company's

survival. If a recovery accelerates, having dry powder positions firms to move quickly ahead of potential rival bids.

Are New Fed Measures Here to Stay?

Historically, market participants favor U.S. Treasury securities in times of stress over risky investments, such as equities. Through this “flight to safety,” as more Treasuries are bought and the price rises, yields fall and provide a signal that investors are allocating more dollars toward safe investments. The yields on these safe assets are often thought of as the risk free rate.

Investors value the future claims on cash flows from their equities by applying a discount rate which implies a certain price today. Based on the Capital Asset Pricing Model, the discount rate is comprised of the risk-free rate and the Equity Risk Premium. Historically, the discount rate almost always increases during times of stress. In times of market stress, we would expect to see an increase in the Equity Risk Premium component and a lower risk-free rate. This leads to a higher overall discount rate for equity cash flows.

However, the Fed’s quantitative easing program has expanded to purchasing not only Treasury securities and government agency mortgage-backed-securities, but also ETFs of both Investment Grade and Non-Investment Grade corporate bonds. This can be interpreted to mean the Fed is supporting individual businesses whom comprise these ETFs, as opposed to supporting general business conditions. In the current environment, both lower borrowing costs and lower business risk could co-exist, leading to lower discount rates for equity cash flows.

COVID-19 has caused downward revision of equity earnings, but market expectations now incorporate a view that the Fed’s accommodative policy will persist indefinitely into the future. The net effect is that equity valuations may actually rise even from current levels.

It’s Not Too Early to Think About a Negative Interest Rate Policy

The Fed has been committed to using its full range of monetary policy tools to support the U.S. economy during COVID-19. However, one tool currently not being considered is a Negative Interest Rate Policy (NIRP). Unlike the European Central Bank and the Bank of Japan, the Fed has steered clear of NIRP, citing concerns around the overall efficacy and potential repercussions on intermediaries, money markets and financial institutions.

Here is how NIRP could impact corporate financing and investment decisions:

Cost of Debt and Equity

Capital Structure

Investment Decisions

Shareholder Distributions

Pensions

Not all Angels That Fall are Equal

From the Great Recession to the pre-COVID-19 market peak in February 2020, the accommodative environment and inexpensive borrowing costs led to the rise of BBB-rated debt to $2.8T by the end of 2019 – companies were willing to come down the Investment Grade (IG) rating spectrum for M&A and shareholder distributions.

COVID-19 and the recessionary environment helped facilitate the downgrade of 17 North American firms from Investment Grade (IG) to High Yield (HY), commonly referred to as fallen angels. This means that they reached the point where a majority of IG ratings from Moody's, S&P, and/or Fitch were lost.

As a result, about $130bn of debt was absorbed by the HY market, and a large amount of debt from "at-risk" firms still remains. We estimate ~158 additional companies remain at-risk of becoming fallen angels; these firms currently have ~$840bn of outstanding debt. Many of these firms are actively taking actions to protect their IG ratings.

We noticed some interesting trends among the slightly larger pool of 22 fallen angels over the last 12 months: Several firms opted not to cut all costs to defend IG and retained dividends in the transition to HY.

Typically, firms will cut discretionary costs to retain their IG rating (absent of M&A); however, four firms retained their dividends. The rating agencies generally commented on how preserving the dividend would slow deleveraging trajectories and accelerate fallen angel status. In this light, these four companies remain in stark contrast to the 187 S&P 1500 firms YTD that have announced dividend cuts/eliminations.

Equity and debt market trajectories can diverge, based on sector and credibility of potential pathways back to IG. Though each situation is different, fallen angels' underperform their sectors by ~50% in the two years leading up to fallen angel status; and another 15% in the 5-30 days thereafter. However, not all angels who fall are equal.

Cyclical or businesses directly impacted by COVID-19 had milder equity underperformance versus their sector leading up to fallen angel status (given the sector had already

underperformed the market), but continued their downward trajectory thereafter. Debt spreads for these firms increased several hundred basis points in the weeks prior to downgrade.

In contrast, non-cyclical or firms less-directly impacted by COVID-19 experienced greater equity underperformance leading up to fallen angel status, but generally did not continue a downward trajectory thereafter. In some instances, their debt spreads were only higher by 100-200 basis points. When the market perceives a credible pathway back to IG after becoming a fallen angel, both the credit and equity side can remain resilient.

Although COVID-19 has contributed to variances in market reactions for certain fallen angels, history has shown that eventually fallen angel debt yields will likely converge to the HY index (absent a pathway to IG). Investors will begin to treat these issuers similarly to businesses in their respective ratings and industry categories.

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